McDONNELL INVESTMENT MANAGEMENT

Fixed Income Commentary ✧ February 2018

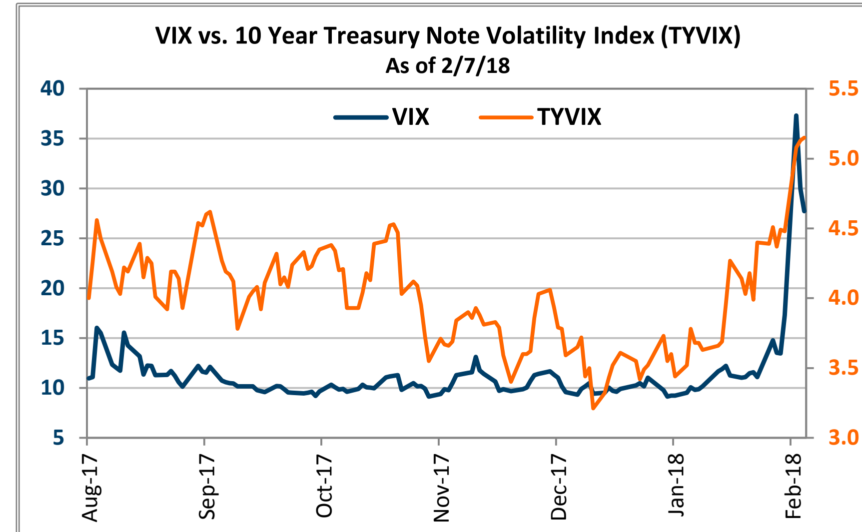
Market Overview

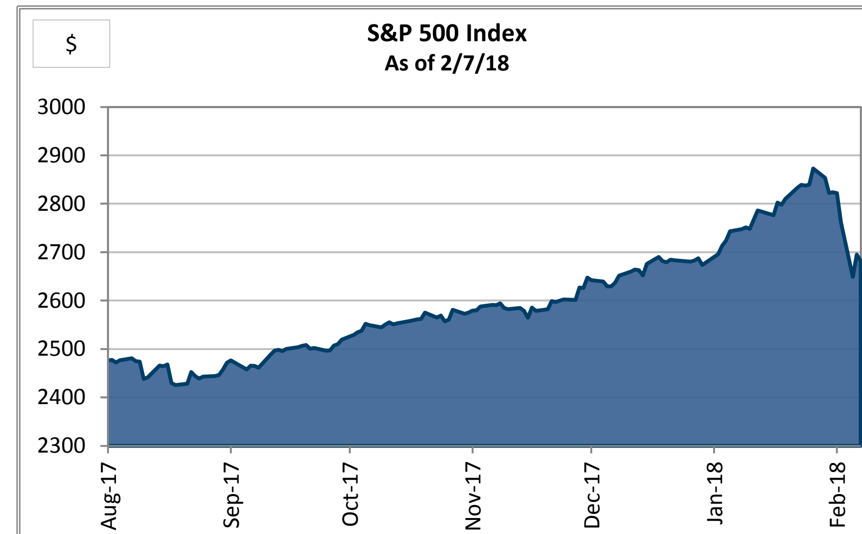
Jim Grabovac, CFA

Complacency in the capital markets received a stunning comeuppance as the year began; first with a spike higher in interest rates, which in turn helped trigger a correction in equity markets worldwide. But the unraveling of the market moved into high gear with the meltdown of so-called 'short-volatility' equity strategies, which in their simplest form, sought to provide investors with returns commensurate with being short the VIX Index. The VIX is a Chicago Board Options Exchange Index designed to reflect the implied volatility of near-term option prices on the S&P 500 Index. Trading in the most prominent short-volatility products was halted, and the remaining assets of what had been the most actively utilized product await liquidation. Although the equity market action was less dramatic than the collapse in 1987, it was eerily reminiscent from the standpoint of 'short-volatility' strategies playing a critical role in exacerbating each debacle. The initial move higher in rates, ironically, seemed in part to be fueled by equity market euphoria as US equity indices scored new all-time highs on 14 of the first 18 trading days in January. This market action combined with a coordinated uplift in global growth and the slashing of the corporate tax rate prompted even sober-minded analysts to begin thinking that resurgent economic growth and inflation might force the Fed to adopt more aggressive monetary tightening than had been anticipated. Bond bearishness persisted despite the upheaval in equities.

Despite the swift rise in rates as the year began, persistent dollar weakness has remained a feature of the broader capital market framework. Even as some analysts began to contemplate a more aggressive Fed policy trajectory, the greenback failed to find a strong bid. The dollar peaked at the beginning of 2017; and since that time has weakened by nearly 18% versus the Euro, 13% versus the Sterling, 6% versus the Yen and nearly 10% versus the Chinese renminbi. As of this writing, the dollar was beginning to show nascent signs of strengthening, but it has been a conspicuously weak performer for the past 13 months. Dollar weakness also contributed to the recovery in crude oil which rallied 18% over the same period. With heightened fixed income investor concern over the potential for higher inflation, it is noteworthy that significant dollar weakness failed to translate into any significant pickup in inflationary pressures last year. The Personal Consumption Expenditures Index, a favorite inflation indicator for the Federal Reserve, was flat while the Core PCE actually weakened over the past year. The dollar has not been a major monetary policy input recently, but if it were to find a foothold, it could influence the requisite pace of policy tightening over the medium-term horizon.

- Treasury rates rose amid fears of a more restrictive monetary regime in response to a synchronized upturn in global growth.
- Despite a sharp deceleration in supply, yields in the municipal market moved higher in sympathy with Treasuries and the yield curve steepened.
- Spread markets mostly outperformed during the month as investors continued to stretch for yield despite the broader backup in rates.
- So-called 'short-volatility' equity strategies imploded as a modest equity market correction turned into a full-scale rout which sent the VIX Index higher by nearly 5-fold as traders desperately cut losses.
- The dollar added to last year's losses, weakening against all major currencies.



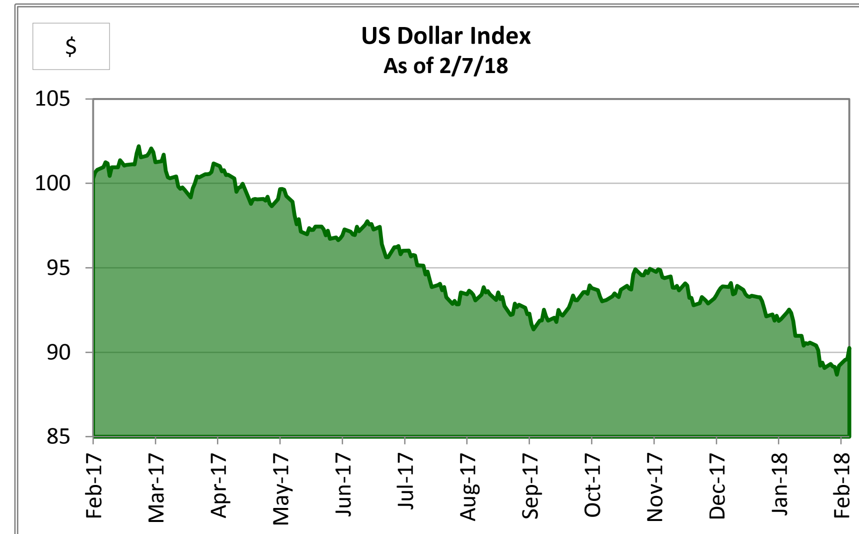


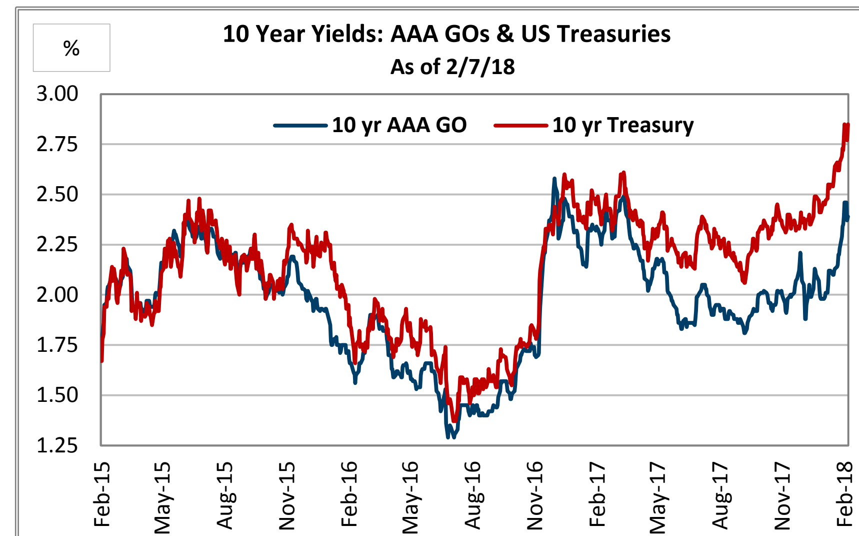
Sources: Bloomberg.
Please refer to the Notes and Disclosures for additional information.

Fixed Income Commentary ✧ February 2018

Volatility of the geopolitical variety was more subdued although potential flashpoints remain omnipresent as the process of governing becomes seemingly more intractable across the globe. Angela Merkel reached tentative agreement in negotiations to conclude her 4-month long quest to form a government. Analysts expect the coalition accord will be approved. In the UK, Prime Minister May's government remains largely stalled in its efforts to negotiate the terms of its future trade and customs relationship with the EU, amid deep divisions within her own party. The national election in Italy awaits in March, with the potential to add to investor concerns if Euro-sceptic parties show momentum. Domestically, the US Government experienced a brief shutdown in January and legislators appear to have narrowly averted another shutdown by passing a 2-year package that raises spending caps on both defense and domestic programs and increases the debt-ceiling. The president is expected to sign the legislation into law. The package will stabilize government funding but also widen future deficits, which on the heels of the $1.5T tax cut, are once again becoming an area of investor concern.

Global bond markets have been under persistent synchronized pressure as economic optimism sparked a contagion of fear among market participants across most developed market economies. Ten-year yields have risen 30 to 50 basis points over the past several weeks in the US, Germany, France, Australia and the UK, among others. It is also noteworthy that measures of bond market volatility have risen along with yields and rising equity market volatility. Perhaps the most surprising change to date, has been the lack of a 'flight-to-quality' bid in response to the extreme equity market price action that occurred in recent sessions. Perhaps it is instructive to look back to the market conditions and capital market behavior that prevailed in 1987. As we noted, the breakdown of 'short-volatility' strategies played an important role then as they have now; also, economic growth was accelerating, monetary policy was tightening, bond yields were rising, tax rates had been slashed, stock prices were soaring and a new Fed Chair was taking the helm. The past weeks' events are of far smaller magnitude, but when risk markets ultimately corrected bond yields ratcheted down within hours. We continue to expect the rise in rates to be contained and anticipate a greater impact on risk markets from evolving Federal Reserve policy actions, particularly as it relates to the planned reduction in the size of its balance sheet.





Sources: Bloomberg; Municipal Market Data.
Please refer to the Notes and Disclosures for additional information.

NOTES AND DISCLOSURES

This market outlook is prepared by McDonnell Investment Management, LLC ("MIM") for informational purposes only. The information set forth is neither investment advice nor legal advice. It is presented only to provide information on investment strategies and our view of potential market opportunities. The views expressed by MIM on financial market trends are as of the date of this publication, based on current market conditions and are subject to change without notice. Statements of future expectations, estimates, projections, and other forward-looking statements are based upon available information and MIM's view as of the time of these statements. Accordingly, such statements are inherently speculative as they are based on assumptions that may involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such statements. The data used for this presentation was obtained from publicly available reports. Unmanaged Index/yield returns include the reinvestment of dividends/interest and other earnings and exclude the deduction of advisory fees and other transaction costs a client may incur. It is not possible to invest directly in an unmanaged index. MIM cannot assure that the type of investments discussed herein will outperform any other investment strategy in the future, nor can it guarantee that such investments will present the best or an attractive risk-adjusted investment in the future. There are no assurances that any predicted results discussed herein will actually occur. Past performance is no guarantee of future results.

18W140 Butterfield Road, Suite 1200 • Oakbrook Terrace, IL 60181 • mcdonnellinvestments.com